

QUANTIFIABLE EDGES

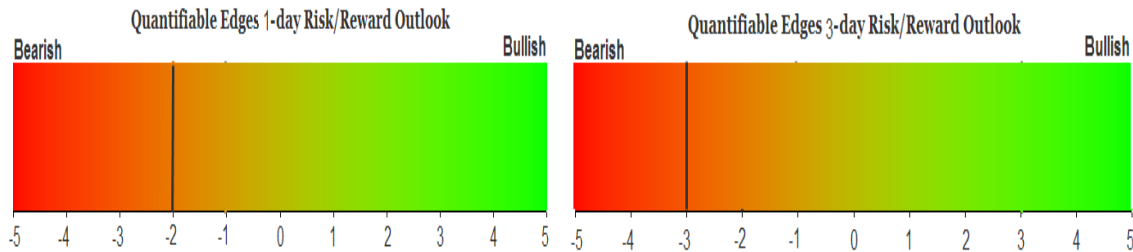
SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

February 22, 2010

Volume 3 Issue 34

Market Overview



Tonight's Research Points

- SPX is short-term overbought and there has been a recent volatility contraction. This doesn't create a huge edge from a swing-trading standpoint, but may be something that day-traders could look to take advantage of.
- The performance in the 5 days since the 2/11 Follow Through Day suggests there is a strong chance the market will be at least testing the January highs prior to another leg down below the Feb lows.
- The VIX:VXV Ratio is currently very low. This suggests there may be an intermediate-term downside edge. This edge does not appear to be as strong as it originally appeared in the 8/25 Letter.
- The Aggregator System is on a short signal at the present time..
- The NDX Aggressive Trend Timer remains flat.

Short-term Outlook – updated 2/22

The Bottom Line

It's beginning to seem as though nothing can make this market pull back. It also appears too many traders are beginning to believe that. The VXO and VIX:VXV Ratio are suggesting the recent rise may be making many investors too complacent. With the Aggregator System short, the short-term edge appears to favor some downside. I'm moderately positioned to take advantage of a selloff. With a bullish intermediate-term outlook I'm not looking to get too aggressive here, though.

Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> or Letters from listed dates for details)

Study Date	Description	Time span	Bias	Avg Max Move
Active				
February 19, 2010	VXO 15% under 10ma. SPX > 200ma	1-5 days	Bearish	-1.80%
February 12, 2010	2 of 3 75% Up Issues % No 10-day high	1-9 days	Bearish	-4.40%
Active - Long Term				
February 22, 2010	VIX:VXV Ratio falls below 0.9	int. term	Bearish	
February 22, 2010	Good 5 days after FTD	int. term	Bullish	
February 16, 2010	Nasdaq/S&P RS Indicator Positive	int. term	Bullish	
February 12, 2010	IBD Follow Through Day	int. term	Bullish	
February 8, 2010	Worden %>200ma - %>40ma > 40	3 - 7 weeks	Bullish	
February 1, 2010	McClellan -60 for 6 days in a row	1-20 days	Bearish	
January 13, 2010	No bearish divergence at high	int. term	Bullish	

If the avg max move is achieved the study will appear in **bold italic blue** and no longer be active.

The Evidence

A sharp selloff in the overnight was almost completely recovered by the time the market opened Friday. There was just a slight gap down. The market then drifted higher until about 1pm and from there it was basically sideways and slightly lower. In the end the indices all closed mildly higher. The SPX gained 0.2% while the Nasdaq was up 0.1% and the Russell 0.4%. Breadth was mildly positive with the NYSE Up Issues % and the Up Volume % both closing around 56%. Total volume increased but not by much.

None of the studies that appeared in the Quantifinder tonight had especially strong edges. One that was interesting looked at the combination of the market being short-term overbought while the 3/10 Offset HV indicator was at an exceptionally low level. The results were a bit bearish but the study didn't take into account the long-term trend of the market. I decided to take that study from the 8/27/09 subscriber letter and break out the results based on the position of the SPX vs. the 200ma.

First let's look at results in an uptrend like now.

SPX 3/10 Offset Historical Volatility closes under 0.25. SPX 2-day RSI > 90. Close > 200ma. Buy on close. Sell X days later. \$100k/trade. 1989 - present.											
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade	
5	15,069.82	71	44	27	61.97	1,302.51	-1,564.47	0.83	1.36	212.25	
4	8,179.95	72	38	34	52.78	1,381.39	-1,303.32	1.06	1.18	113.61	
3	-3,542.58	72	38	34	52.78	1,030.86	-1,256.33	0.82	0.92	-49.20	
2	1,912.12	76	34	42	44.74	879.00	-666.04	1.32	1.07	25.16	
1	-2,788.47	99	49	50	49.49	462.20	-508.73	0.91	0.89	-28.17	

Without a downtrend in place the study no longer appears bearish. It's now a bit of a coinflip over the next few days. So what does this mean for the results below the 200ma?

SPX 3/10 Offset Historical Volatility closes under 0.25. SPX 2-day RSI > 90. Close < 200ma. Buy on close. Sell X days later. \$100k/trade. 1989 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
5	-21,556.67	18	8	10	44.44	1,114.98	-3,047.65	0.37	0.29	-1,197.59
4	-22,178.89	18	5	13	27.78	1,192.56	-2,164.75	0.55	0.21	-1,232.16
3	-23,058.97	18	5	13	27.78	962.94	-2,144.13	0.45	0.17	-1,281.05
2	-25,168.36	18	2	16	11.11	1,415.62	-1,749.97	0.81	0.10	-1,398.24
1	-17,437.21	19	5	14	26.32	940.82	-1,581.52	0.59	0.21	-917.75

As you'd expect these are exceptionally weak – especially over the 1st 2 days where 89% of instances sell off and the average trade closes down 1.4%.

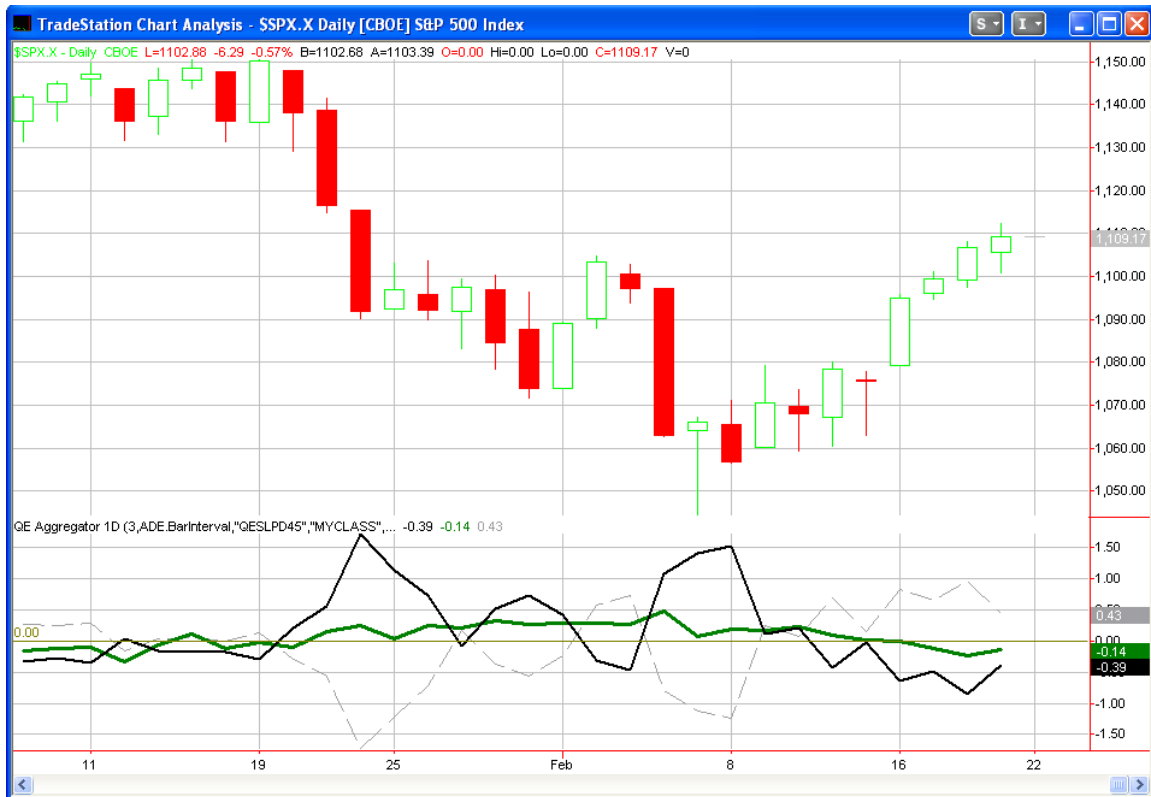
It appears the low HV while the market is overbought isn't helping to provide much of an edge at this point. Still, for those traders who utilize the intraday timeframe, the 3/10 Offset HV may be useful in trading an early-morning consolidation breakout. I discussed this in the study of Opening Range Breakouts (ORBs) that I published in the fall. Below is a link to that study.

[ORBs Study.pdf](#)

I generally only trade ORBs in the direction of the Aggregator bias since I prefer to have a swing-timeframe edge at my back with my daytrades. While it's not a trade I could possibly track in the subscriber letter, should it occur, I may look to trade an early morning breakdown using daytrade risk and trade management.

There were also a couple of studies in the Quantifinder that look at market behavior following option expiration. One was based on the price action of the last week and the other looked at price and volume action on op-ex Friday. Results of these conflicted and neither was terribly strong so I'm not inclined to draw any conclusions from them under these circumstances.

I have updated the [Aggregator](#) chart below.



With no new studies qualifying for the Active Studies List, there wasn't much change in the green Aggregator line. It is still squarely below 0, indicating net bearish expectations from the studies over the next few days. With the move up slowing down a little the black Differential line rose a little. Still, that too is well below 0 as the SPX has strongly outperformed expectations over the last few days. Both lines below 0 is considered a bearish configuration. It signifies the outlook is for downside and the market is overbought. It has historically provided a downside edge and it has the Aggregator System remaining short for at least another day.

Looking ahead to tomorrow, we will still need to see more bullish evidence in order to move the green Aggregator line back above 0. Meanwhile the pivot level for the black Differential line is 1,098.34 on Monday. In other words, it would take a close at or below this level in order to move the Differential line back above 0.

Intermediate-term Outlook (2 weeks – 2 months)– updated 2/22 – bullish

It has now been 5 trading days since the 2/11 classic Follow Through Day (a gain of 1% or more on higher volume). In the February 1, 2008 blog post I examined implications of market action directly after FTD's. In that post I found this early action to be a strong indication of whether a FTD was likely to succeed or not. I've pasted the pertinent information from that post below:

Is short-term success or failure indicative of long-term success or failure?

One interesting claim that IBD sometimes makes about Follow Through Days is that those that fail normally do so shortly after the Follow Through Day. I decided to also

look at this concept tonight.

I broke the 64 Follow Through Days in my study up into two groups – the successful ones and the unsuccessful ones – to see if their early performance hinted at their chance of longer-term success. Below are the breakdowns – same as above - \$100,000/trade, long at the close of the Follow Through Day, and exit X days later.

Early action after Follow Through Days that eventually “succeeded”:

Successful FTD's										
Days Held	Net Profit	Trades	% Profitable	Wins	Losses	Avg Win	Avg Loss	Win/Loss Ratio	Avg Trade	ProfitFactor
10	\$78,896.61	35	71.43	25	10	\$3,547.95	(\$980.23)	3.62	\$2,254.19	9.05
5	\$62,786.42	35	77.14	27	8	\$2,795.15	(\$1,585.33)	1.76	\$1,793.90	5.95
4	\$53,316.64	35	68.57	24	11	\$2,754.82	(\$1,163.56)	2.37	\$1,523.33	5.17
3	\$52,666.31	35	65.71	23	12	\$2,773.65	(\$927.31)	2.99	\$1,504.75	5.73
2	\$52,742.34	35	71.43	25	10	\$2,508.30	(\$996.53)	2.52	\$1,506.92	6.29
1	\$25,494.79	35	57.14	20	15	\$1,690.62	(\$554.51)	3.05	\$728.42	4.07

Right off the bat most of these posted nice gains. The short-term winners among the group averaged another 2-3% upside in the first week. The short-term losers suffered 1-1.5% drops on average. Net profits were substantial.

Early action after Follow Through Days that eventually “failed”:

Unsuccessful FTD's										
Days Held	Net Profit	Trades	% Profitable	Wins	Losses	Avg Win	Avg Loss	Win/Loss Ratio	Avg Trade	ProfitFactor
10	(\$46,481.75)	29	34.48	10	19	\$1,818.19	(\$3,403.35)	0.53	(\$1,602.82)	0.28
5	(\$17,048.80)	29	48.28	14	15	\$1,651.24	(\$2,677.74)	0.62	(\$587.89)	0.58
4	(\$15,244.85)	29	44.83	13	16	\$1,465.84	(\$2,143.80)	0.68	(\$525.68)	0.56
3	(\$18,577.18)	29	44.83	13	16	\$1,358.57	(\$2,264.91)	0.60	(\$640.59)	0.49
2	(\$22,069.98)	29	37.93	11	18	\$764.94	(\$1,693.58)	0.45	(\$761.03)	0.28
1	(\$7,847.64)	29	41.38	12	17	\$425.76	(\$762.16)	0.56	(\$270.61)	0.39

Those that eventually failed tended to show signs of failure right away. Notable here is the average loss was appreciably higher than the average gain.

A basic rule of thumb is that the success or failure was determined with about 67% reliability within the first week after a Follow Through Day. For instance, note there were 41 total trades that were in the black after 5 days. About 2/3 of them went on to “successful” rallies. The same ratio applies for the losers. There were 23 losers after 5 days. 15 of them ended up with “failed” rallies and the other 8 were “successful”. The 2/3 rule holds fairly accurate whether you are looking at winners or losers over any period from 1-5 days after the Follow Through Day.

In the current situation “success” would be a move to 1,147.41 or higher. This is just barely under the recent high of 1,150.45. In other words, based on this study, there appears to be a good chance the market will at least test its January highs before it breaks

its February lows. This is consistent with what some breadth-based studies have been suggesting as well. One thing to note is that there still has not been a FTD under the current IBD definition, so it will be interesting to see what happens here.

In the 8/25/08 Letter I took a look at the VIX:VXV Ratio. The VIX measures option volatility out 30 days. The VXV uses the same calculation but measures out 90 days. Their values and movement are frequently quite close. When the VIX moves significantly above or below the VXV then that can provide us clues about volatility expectations for the short and intermediate-term. It can also serve as a directional indicator.

Below is a study which shows how the market has performed in the past when the ratio has closed below 0.90. The VXV has only been around since December of 2006. The CBOE did calculate it back several more years though. I have been able to acquire their data back to 2002 and have included that in the below test. (This test is updated this evening.)

VIX:VXV Ratio closes below 0.9. Buy SPX on close. Sell X days later. \$100k/trade. 2002 - present.										
X Days	All: Net Profit	All: Total Trades	All: Winning Trades	All: Losing Trades	All: % Profitable	All: Avg Winning Trade	All: Avg Losing Trade	All: Win/Loss Ratio	All: ProfitFactor	All: Avg Trade
20	-4,442.58	43	22	21	51.16	2,186.37	-2,502.04	0.87	0.92	-103.32
19	-10,329.29	43	21	22	48.84	2,220.84	-2,589.40	0.86	0.82	-240.22
18	-10,876.03	44	24	20	54.55	1,905.02	-2,829.82	0.67	0.81	-247.18
17	-14,987.62	47	21	26	44.68	2,028.94	-2,215.21	0.92	0.74	-318.89
16	-16,199.26	48	23	25	47.92	1,912.11	-2,407.11	0.79	0.73	-337.48
15	-21,761.97	50	21	29	42.00	1,949.85	-2,162.37	0.90	0.65	-435.24
14	-10,729.05	51	27	24	52.94	1,448.82	-2,076.96	0.70	0.78	-210.37
13	-13,941.59	53	27	26	50.94	1,456.47	-2,048.71	0.71	0.74	-263.05
12	-15,839.97	58	28	30	48.28	1,658.39	-2,075.83	0.80	0.75	-273.10
11	-17,699.50	64	29	35	45.31	1,562.96	-1,800.73	0.87	0.72	-276.55
10	-12,567.24	66	32	34	48.48	1,488.73	-1,770.78	0.84	0.79	-190.41
9	-14,368.33	69	34	35	49.28	1,367.34	-1,738.79	0.79	0.76	-208.24
8	-13,688.32	79	39	40	49.37	1,388.88	-1,696.36	0.82	0.80	-173.27
7	-9,774.28	85	41	44	48.24	1,391.65	-1,518.90	0.92	0.85	-114.99
6	2,022.44	94	54	40	57.45	1,072.94	-1,397.90	0.77	1.04	21.52
5	-3,073.73	112	59	53	52.68	1,077.12	-1,257.06	0.86	0.95	-27.44
4	-13,685.22	132	64	68	48.48	975.78	-1,119.64	0.87	0.82	-103.68
3	-3,066.23	165	82	83	49.70	907.91	-933.92	0.97	0.96	-18.58
2	-461.82	224	117	107	52.23	692.06	-761.05	0.91	0.99	-2.06
1	-2,914.87	408	223	185	54.66	452.16	-560.79	0.81	0.97	-7.14

In the 8/25/08 Letter the results appeared substantially more bearish. What we see here is a market that is more likely to struggle rather than a suggestion of a strong selloff. In that Letter I also looked at a strategy that would sell short the SPX on a cross below 0.9 and would cover the position only when the ratio moved back above 1. I have updated those results below:

VIX:VXV Ratio closes below 0.9. Buy SPX on close.
 Sell when VIX:VXV ratio closes > 1. \$100k/trade. 2002 - present.

TradeStation Performance Summary				Collapse 
All Trades				
Total Net Profit	\$15,335.22	Profit Factor	1.48	
Gross Profit	\$47,017.77	Gross Loss	(\$31,682.55)	
Total Number of Trades	18	Percent Profitable	72.22%	
Winning Trades	13	Losing Trades	5	
Even Trades	0			
Avg. Trade Net Profit	\$851.96	Ratio Avg. Win:Avg. Loss	0.57	
Avg. Winning Trade	\$3,616.75	Avg. Losing Trade	(\$6,336.51)	
Largest Winning Trade	\$8,774.18	Largest Losing Trade	(\$13,215.96)	

While these appear to suggest a mild downside edge the stats are not nearly as convincing as they were a year and a half ago. If we look at the individual trade breakdown we can easily see why the stats have changed so dramatically.

VIX:VXV Ratio closes below 0.9. Buy SPX on close. Sell when VIX:VXV ratio closes > 1. \$100k/trade. 2002 - present.				
Date/Time	Signal	Price	% Profit	Run-up DrawDown
01/02/03	Short	\$909.03	5.24%	\$5,425.20
01/24/03	Cover	\$861.40		(\$2,862.20)
08/12/03	Short	\$990.35	(5.38%)	\$999.00
11/17/03	Cover	\$1,043.63		(\$7,330.00)
01/16/04	Short	\$1,139.82	2.90%	\$2,953.65
03/11/04	Cover	\$1,106.79		(\$2,036.67)
03/25/04	Short	\$1,109.28	4.15%	\$4,234.50
08/12/04	Cover	\$1,063.23		(\$3,716.10)
08/25/04	Short	\$1,104.96	(2.28%)	\$1,329.30
10/29/04	Cover	\$1,130.20		(\$3,338.10)
12/09/04	Short	\$1,189.24	3.85%	\$3,974.88
04/15/05	Cover	\$1,143.43		(\$3,349.08)
06/02/05	Short	\$1,204.29	2.28%	\$2,995.47
10/13/05	Cover	\$1,176.84		(\$3,450.31)
11/25/05	Short	\$1,268.25	(2.91%)	\$1,755.78
05/01/06	Cover	\$1,305.19		(\$3,892.98)
07/03/06	Short	\$1,280.19	2.96%	\$3,023.28
07/13/06	Cover	\$1,242.28		\$0.00
08/16/06	Short	\$1,295.43	(8.01%)	\$457.38
02/27/07	Cover	\$1,399.14		(\$12,792.78)
06/19/07	Short	\$1,533.70	2.66%	\$2,805.40
06/26/07	Cover	\$1,492.89		(\$235.30)
10/09/07	Short	\$1,565.15	3.62%	\$4,762.17
11/01/07	Cover	\$1,508.45		(\$689.22)
12/20/07	Short	\$1,460.12	3.32%	\$3,327.24
01/04/08	Cover	\$1,411.62		(\$2,633.64)
05/12/08	Short	\$1,403.58	8.80%	\$9,342.18
06/30/08	Cover	\$1,280.00		(\$2,602.86)
08/21/08	Short	\$1,277.71	4.16%	\$4,717.44
09/09/08	Cover	\$1,224.54		(\$1,975.74)
06/25/09	Short	\$920.26	(13.30%)	\$5,501.52
10/28/09	Cover	\$1,042.63		(\$19,558.80)
11/17/09	Short	\$1,110.32	1.70%	\$2,392.20
11/27/09	Cover	\$1,091.50		(\$185.40)
12/01/09	Short	\$1,108.86	1.54%	\$2,034.00
01/22/10	Cover	\$1,091.76		(\$3,743.10)
02/19/10	Short	\$1,109.17	n/a	\$0.00
open	n/a	\$1,109.17		\$0.00

From the end of June to the end of October there was a strong rally in the face of a low VIX:VXV ratio. Was this rally an anomaly or has the indicator lost its edge? It's tough to tell. My inclination is that the rally over this time period was unusually strong in many ways and just because this indicator got run over then doesn't mean it's entirely useless. So I'll add it to the intermediate-term active studies as something to keep in mind but it won't be factoring in to the Aggregator calculation at this point.

So while we are short-term overbought and a pullback appears imminent, my intermediate-term bias is to the long side. I'm of the opinion that the market will at least test the January highs. If I'm right then I'll be looking for more clues as we approach that level that may hint whether the recent selloff was a warning shot and we're likely in a topping pattern, or whether the rally can gain enough momentum to put in another leg higher beyond the January highs.

Catapult and Capitulative Breadth Statistics

(Catapult Presentation Part 1) (Catapult Presentation Part 2)

Open Catapult Triggers

none

Catapult for ETF's Trades

none

Broad Market Large Cap CBI – 0

Additional New Trade Ideas

A full listing of system triggers can be found at the [system triggers page](#) each night. I will cherry pick some of my favorite setups from the S&P 100 and ETF lists along with occasional other trade ideas to track below.

None tonight. I'm half in with the SPY position and I likely won't increase it without some very compelling evidence. I'm not crazy about getting too aggressive with a counter-trend trade – especially after a follow-through day.

Active Trades Table

Symbol	Entry Date	Entry Price	Current Price	% Gain/Loss	Stop	Notes
SPY(1/4)(s)	2/18/2010	\$110.26	\$111.14	-0.80%		Aggregator
SPY(1/4)(s)	2/18/2010	\$110.91	\$111.14	-0.21%		Aggregator

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